United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-4123 75-4201

United States Court of Appeals
For the Second Circuit

No. 75-4123

IRWIN C. GUILD and BERNICE GUILD,
Appellants-Cross-Appellees,
v.
COMMISSIONER OF INTERNAL REVENUE,
Appellee-Cross-Appellant.

No. 75-4201

JONATHAN LOGAN, INC.,
Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE,
Appellant.

BRIEF FOR APPELLANTS GUILD

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UNITED STATES COURT OF APPEALS
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IRWIN C. GUILD and BERNICE GUILD, Appellant - Cross Appellee,	
v.	Docket No. 75-4123
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COMMISSIONER OF INTERNAL REVENUE Appellant.	

BRIEF
ON BEHALF OF APPELLANTS,
IRWIN C. GUILD AND BERNICE GUILD

Preliminary Statement

The decision of the Tax Court in this case was rendered by Judge Darrell D. Wiles. His opinion is reported at Tax Court Memorandum Decisions 1974-237, Commerce Clearing House 33 TCM 1045, Prentice Hall Memo TC ¶74237.

Issue Presented for Review

Whether the Tax Court erred in holding that the

Appellants, Irwin C. Guild ("Guild") and Bernice Guild realized ordinary taxable income on the purchase by Guild of 6500 shares of Jonathan Logan, Inc. common stock in 1967 pursuant to the terms of a settlement agreement between them.

The Appeal

Appellants Irwin C. Guild and Bernice Guild appeal to this Court from the decision of the Tax Court determining a deficiency in income taxes to be due from appellants for the year 1967.

The Tax Court held that Guild's purchase of 6500 shares of Jonathan Logan, Inc. ("Logan") common stock resulted in his realization of ordinary income (equal to the difference between the fair market value of 6500 shares of Logan stock and the price which Guild paid for such shares) because (a) the Logan stock was not transferred to Guild pursuant to an exercise of a statutory stock option since he had no such option to exercise, and (b) that even if Guild had such an option he failed to exercise it in the manner prescribed in Section 1.421-1(e), Income Tax Regs.

The Tax Court was wrong in both of these conclusions.

The Facts

1. Irwin C. Guild and Bernice Guild are husband and wife residing at New York, New York. Their Federal income tax return for the calendar year 1967 was prepared and filed

under the cash receipts and disbursements method with the District Director of Internal Revenue, New York, New York (Stipulation, Paragraph 1).

2. Logan is a corporation organized under the laws of the State of Delaware. Its principal place of business is 3901 Liberty Avenue, North Bergen, New Jersey 07047. Logan's Federal income tax return for the calendar year 1967 was filed with the District Director of Internal Revenue for the District of Newark at Newark, New Jersey (Stipulation, Paragraph 2).

3. Prior to September 24, 1963 Guild had been engaged as the president of a division of one of Logan's competitors. (App. p. 127a). In September 1963, Guild was induced to go to work for Logan and on September 24, 1963, entered into an employment agreement and commenced his employment with Logan. (Stipulation, Paragraph 3). The employment agreement was executed in New York City and Guild's services for Logan were performed there. (App. p. 131a).

4. By the terms of Guild's employment agreement (Joint Exhibit 2-B; hereafter the Employment Agreement) he was engaged as Executive Sales Manager of the R & K Originals Division of Logan. The provisions of the Employment Agreement which are material to the issues in this case are as follows:

> "2. The term of this agreement shall be for two years and four months from September 1, 1963 to December 31, 1965, subject to earlier termination

by us in the event of your death or inability to perform the services required hereunder due to physical disability. Neither the term of this agreement nor the exercise dates of the stock option hereinafter referred to shall be affected by the facts that certain portions of said option are exercisable only after the expiration date of this agreement, it being intended that such portions of the option shall be exercisable by Irwin C. Guild if you continue in the employ of the Company after the expiration date of this agreement.

3. Your compensation for the services to be performed hereunder shall be a salary at the rate of $30,000 per annum. In addition, you shall receive an expense allowance of $25,000 per annum, for which you shall not be required to account to the Company. Said salary and expense allowance shall be payable in such installments or at such times as is customary for executive personnel of the Company.

As a further inducement to enter into the employment of the Company we agree to and hereby do grant to you, a restricted stock option for the purchase of 25,000 shares of the common stock of the Company. Such option shall be in the form and upon the terms and conditions set forth in Exhibit A annexed hereto.

4.***

5.***

6.***

7.***

8.***

9. This agreement constitutes our entire understanding and may not be amended, terminated or discharged orally."

5. Exhibit A referred to in the Employment Agreement was the form of stock option agreement, which, dated September 24, 1963 was entered into simultaneously with the Employment Agreement. By the terms thereof (hereafter the Stock Option Agreement) Logan granted to Guild options to purchase 25,000 shares of its common stock at $15.46 per share. (Joint Exhibit 3-C).

The stock options so granted by Logan to Guild were, when granted, "Restricted Stock Option(s)" within the meaning of Section 421 of the Internal Revenue Code of 1954 (hereafter the "Code") as such Section existed prior to the amendment on February 26, 1964 of Part II of Subchapter D of Chapter 1 of the Code by public law 88-272, Section 221(a) (Stipulation, Paragraph 5) and were "Restricted Stock Option(s)" within the meaning of Section 424(b) of the Code as thereafter in effect.

6. In respects material to this case, the Stock Option Agreement contained the following provisions:

"September 24, 1963

Mr. Irwin C. Guild
19 East 33 Street
New York, New York

Dear Mr. Guild:

Pursuant to and in consideration of your entering into an employment agreement with us this day to act as Executive Sales Manager of our R & K Division, the undersigned, Jonathan Logan, Inc., a Delaware corporation, hereinafter called the "Company", has this day granted to you an option to purchase the number of shares of its Common Stock as set forth below, subject to and upon the terms and conditions hereinafter stated. The terms and conditions of said option and its exercise are as follows:

1. Number of Shares: The number of shares subject to this option is twenty-five thousand shares.

2. Option Price: The option price per share is eighty-five percent (85%) of the highest price per share on the New York Stock Exchange on September 24, 1963.

3. Expiration Date: 3:00 p.m. (New York City time) on September 24, 1968.

4. Exercise Period and Conditions of Rights of Exercise: Provided that at the time of exercise you are employed by the Company or a subsidiary of the Company, this option may be exercised as follows:

(a) During the period of twelve (12) months from the date hereof, this option may not be exercised to any extent.

(b) During the period commencing twelve (12) months from the date hereof and continuing until the expiration date of the option, this option may be exercised from time to time to the extent of 10,000 shares.

(c) During the period commencing April 1, 1965 and continuing until the expiration date of the option, this option may be exercised from time to time to the extent of an additional 5000 shares upon the condition that that [sic] the "Gross Sales" and the "Net Profit" of the R & K Division for the 12 months period ending December 31, 1964 shall each have exceeded the "Gross Sales" and "Net Profit", respectively of the R & K Division for the 12 months period ending December 31, 1963 by at least 5%. If said Gross Sales and Net Profit for the 12 months period ending December 31, 1964 shall not each exceed the Gross Sales and Net Profit for the 12 months period ending December 31, 1963, by at least 5%, then this option shall, ipso facto terminate as to said 5000 shares, and shall at no time be exercisable by you with respect thereto.

During the period commencing April 1, 1966 and continuing until the expiration date of the option, this option may be exercised from time to time to the extent of an additional 5000 shares upon the condition that that [sic] the "Gross Sales" and the "Net Profit" of the R & K Division for the 12 months period ending December 31, 1965 shall each have exceeded the "Gross Sales" and the "Net Profit", respectively of the R & K Division for the 12 months period ending December 31, 1963 by at least 15%. If said Gross Sales and Net Profit for the twelve months period ending December 31, 1965 shall not each exceed the Gross Sales and Net Profit for the 12 months period ending December 31, 1963 by at least 15% then this option shall, ipso facto terminate as to said 5000 shares, and shall at no time be exercisable by you with respect thereto.

During the period commencing April 1, 1967 and continuing until the expiration date of the option, this option may be exercised from time to time to the extent, of an additional 5000 shares upon the condition that that [sic] the "Gross Sales" and the "Net Profit" of the R & K Division for the 12 months period ending December 31, 1966 shall each have

exceeded the "Gross Sales" and the "Net Profit", respectively of the R & K Division for the 12 months period ending December 31, 1963 by at least 25%. If said Gross Sales and Net Profit for the 12 months period ending December 31, 1966 shall not exceed the Gross Sales and Net Profit for the 12 months period ending December 31, 1963 by at least 25% then this option shall, ipso facto terminate as to said 5000 shares, and shall at no time be exercisable by you with respect thereto.

As used in this agreement with respect to the years ending December 31, 1964, December 31, 1965 and December 31, 1966 the terms "Gross Sales" and "Net Profit" shall mean the gross sales and net profit before income taxes, respectively of the R & K Division, as determined by the auditors for the Company and included in the certified Consolidated Statement of Income of the Company which forms a part of the Annual Report to Stockholders for each of said years. Gross Sales and Net Profit of the R & K Division shall include not only sales and profit from the manufacture and sale of the line of misses' dresses currently produced by the Division, but also sales and profit from the manufacture of any other line of apparel which may hereafter be undertaken by the Division.

* * *

All determination by the auditors for the Company of Gross Sales and "Net Profit" shall be binding and conclusive upon all parties hereto.

5. Termination of Employment and Death: If your employment by the Company or subsidiary terminates, this option shall cease for all purposes, except that if such termination shall occur during the Exercise Period, this option may thereafter be exercised (to the extent to which it was exercisable at the time of such termination) during a period of three (3) months from the date of such termination, but not, in any event, later than the Expiration Date; provided that if during the Exercise Period (i) your employment is terminated by death or (ii) your employment terminates and death occurs within three (3) months thereafter, this option may thereafter be exercised (to the extent to which it was exercisable at the time of your death) during a period of six (6) months after your death, but not, in any event, later than the Expiration Date. Notwithstanding the foregoing provisions, if your employment is terminated for cause, all of your rights hereunder shall expire immediately upon such termination."

6. Manner of exercise: Should you desire to exercise your option to purchase any of the shares which at the time you are entitled to purchase hereunder, you shall give written notice of such election to the Company . . . specifying the number of shares to be purchased which notice shall be accompanied by payment to the Company in cash (or certified or bank cashier's check) of the purchase price for the number of shares being purchased. At the same time, you shall represent and agree with the Company that you are acquiring the shares for investment purposes. The Company shall not be obligated to deliver any shares until they have been listed upon each Stock Exchange . . . and not until there has been compliance with such laws and regulations as the Company may deem applicable . . . .Before issuing any shares upon exercise, the Company may require you to furnish a written representation that you are acquiring the shares for investment and not for distribution.

(Joint Exhibit 3-C)

7. The Stock Option Agreement contained the following subscription signed by Guild:

"I hereby agree to hold for investment any shares acquired hereunder. I accept this option subject to all the terms and conditions set forth herein.

Irwin C. Guild
Irwin C. Guild"

(Joint Exhibit 3-C)

8. The "gross sales" and "net profit" of the R & K Division of Logan for each of the twelve month periods ending December 31, 1964, December 31, 1965 and December 31, 1966 exceeded the requirements applicable thereto which were specified in Section 4 of the Stock Option Agreement. (Stipulation, Paragraph 14).

9. Guild exercised his rights with respect to the 10,000 shares to which Section 4(b) of the Stock Option Agreement was applicable, and there is no issue between any of the

parties to this consolidated case with respect to the tax consequences to Guild or Logan arising from such exercise. (Stipulation, Paragraph 6).

In payment for such shares Guild tendered to Logan and Logan accepted Guild's uncertified check for $154,600. (Guild Exhibit 16). Guild does not recollect that he was ever required by Logan to give written notice of his intention to effect such exercise. (App. p. 135a).

10. Guild's employment by Logan continued from its inception until terminated by Logan by a notice addressed to him on November 23, 1964, stated to be effective as of November 10, 1964. (Stipulation, Paragraph 7; Joint Exhibit 4-D).

11. Guild's discharge occurred on or about November 10 without prior notice to him. App. p. 130a). Guild thereupon arranged to meet with Richard Schwartz, Logan's President, and at such meeting demanded of Mr. Schwartz that Logan transfer to him the 15,000 shares of Logan's common stock which remained subject to his option. Guild was at all times ready, willing and able to pay the option price of $15.46 a share for the $15,000 shares which he was demanding, (App. p. 132a), and in fact, had a blank check in his pocket which he was prepared to fill out, sign and deliver to Logan. App. p. 137a). Guild's demand was rejected by Richard Schwartz who told Guild that he would get nothing from Logan and that he would have to sue Logan to enforce his rights. (App. p. 136a).

On various occasions subsequent to his discharge in

November, 1964 and continuing at least until January 15, 1965 Guild repeated his demands to Mr. Richard Schwartz. All such demands were rejected. (App. p. 133a).

12. During the calendar year 1964 Guild received from Logan salary amounting to $26,538.32 and an expense allowance of $22,864.93. (Stipulation, Paragraph 7).

13. On January 15, 1965, Guild commenced a civil action against Logan in the United States District Court for the Southern District of New York. Subsequently, by agreement of counsel for Guild and for Logan, such action was dismissed without prejudice to either party and simultaneously, on or about April 15, 1965, a new action was instituted by Guild against Logan in the Supreme Court of the State of New York for the County of New York. (Index No. 16223/1965), (Joint Exhibit 6-F). In all material respects the complaint in the New York Supreme Court action was identical with the complaint in the Federal Court action. (Stipulation, Paragraph 9).

14. Guild's complaint alleged his entitlement to salary at the rate of $55,000 per annum (notwithstanding that the Employment Agreement specified a salary of $30,000 per annum and an expense allowance of $25,000). In addition thereto, the complaint alleged that Logan was required to provide Guild with other prerequisites, such as cash allowances, use of an automobile and the servicing and maintenance

thereof, unlimited credit card facilities, health insurance and trips to foreign countries. The complaint alleged that by reason of the wrongful termination of Guild's employment prior to the expiration of its term which was specified to be December 31, 1965, Guild had sustained damages aggregating $79,133.84, as follows:

"Salary	$62,639.00
Cash Expense Allowance	3,410.00
Automobile	4,100.00
Credit Card (personal use)	2,733.00
Trips abroad	6,000.00
Health insurance	251.84"

The complaint also sought a decree directing Logan to permit Guild to exercise his option as to the 15,000 shares of Logan's common stock, or in the alternative, damages representing the reasonable value of the options with respect to such 15,000 shares. (Joint Exhibit 6-F).

15. Logan answered to the complaint and, in general, alleged that Guild had been discharged for cause. As separate defenses to the complaint, Logan asserted that insofar as the complaint sought damages for salary in excess of the contract rate of $30,000 per annum, for a fixed cash expense allowance, automobile use, and other fringe benefits, such claims were barred by the statute of frauds and by the parol evidence rule. (Joint Exhibit 7-G).

16. On or about November 20, 1967, Guild's action against Logan was settled. (Stipulation, Paragraph 12). In connection with such settlement the parties executed and exchanged a stipulation of discontinuance and general releases, (Joint Exhibits 10-J, 11-K and 12-L) and a settlement agreement in the form of a letter dated November 20, 1967, (Joint Exhibit 13-M; the "Settlement Agreement").

17. Pursuant to the Settlement Agreement, Guild received certificates for 6500 shares of Logan's common stock and paid to Logan $100,490. (Stipulation, Paragraph 13).

18. By the Settlement Agreement Logan acknowledged Guild's attempt to exercise his option with respect to the 15,000 shares which continued to be subject to the Stock Option Agreement and recognized Guild's right as to 6500 shares of Logan's common stock "upon the terms and conditions of the option". (Joint Exhibit 13-M).

19. The 6500 shares of Logan's common stock which were delivered to Guild were issued against Logan's treasury stock, (Guild Exhibit 14), and were recorded in Logan's books as having been issued upon the exercise of stock options, (Guild Exhibit 15).

20. After being discharged by Logan, Guild obtained employment from L'Aiglon Apparel, Inc. which employment

commenced on or about January 1, 1965. During the calendar year 1965 Guild received compensation from L'Aiglon Apparel, Inc. in the amount of $46,209.37, (Stipulation, Paragraph 15) and the free use of a 1965 Cadillac (page 8 of Exhibit D annexed to Joint Exhibit 9-I).

21. In connection with Guild's actions against Logan, he had entered with his then counsel into a contingent retainer agreement. On the settlement of Guild's action against Logan, such counsel became entitled under such agreement to receive from Guild 388 shares of Logan's common stock out of the 6500 shares received by Guild upon the payment by such counsel to Guild of $5,999.48. On or about November 30, 1967 Guild assigned and delivered to such counsel certificates for 388 shares of Logan's common stock for which he was paid by such counsel the sum of $5,999.48.

The fair market value of 388 shares of Logan common stock at the time of delivery thereof to Guild's counsel was $57 per share, or an aggregate of $22,116. (Stipulation, Paragraph 17).

22. The fair market value of Logan's common stock on November 20, 1967 was $54.50 per share. (Stipulation, Paragraph 18).

Appellants' Argument

I

THE 6500 SHARES OF LOGAN'S COMMON STOCK WERE RECEIVED BY GUILD PURSUANT TO THE STOCK OPTION AGREEMENT

A.

The Tax Court reasoned that at the time of the Guild's discharge in November, 1964, there were no options available for exercise since the next exercise period would first commence on April 1, 1965 and that the settlement agreement used the medium of a bargain stock sale as compensation to Guild "for damages arising out of the breach of his entire employment agreement of which the stock option was a part."

We submit that the Tax Court was wrong in its conclusions. The starting point of the Tax Court's position is to be found in Section 5 of the Stock Option Agreement. The Tax Court read that section to mean that without regard to the manner in which Guild's employment was terminated he had no rights under the Stock Option Agreement if the termination of his employment occurred at any time prior to April 1, 1965.

We believe that such a reading of the agreement is erroneous. The Stock Option Agreement makes it perfectly clear (a) that if Guild voluntarily terminated his employment prior to April 1, 1965, he would lose the options which accrued

in respect of his 1964 performance, and (b) that if his employment were terminated for cause on or after such April 1, his right to exercise the options would also be lost. However, the agreement nowhere states that Logan could deprive Guild of his right to exercise his options by discharging him without cause prior to April 1.

The contrary proposition is true. Logan was under a duty implied in the contract to do nothing to prevent Guild's rights from accruing. The hiatus in the Stock Option Agreement was merely in the drafting and not in the extent of Logan's obligation to Guild. The law of the State of New York by which the contract was governed did not require that Logan be expressly precluded from depriving Guild of his option rights by wrongfully discharging him. The law is rather to the contrary, and we can do no better in this context than to set forth the immortal words of the late Justice Cardozo in Wood v. Duff-Gordon, 222 N.Y. 88, 90.

> "The law has outgrown its primitive state of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view to-day. A promise may be lacking, and yet the whole writing may be 'instinct with an obligation,' imperfectly expressed (Scott, J., in McCall Co. v. Wright, 133 App. Div. 62; Moran v. Standard Oil Co., 211 N.Y. 187, 198). If that is so, there is a contract." (Emphasis ours).

We think that an illustration will make the point crystal clear.

Let us assume that Guild's employment was wrongfully terminated by Logan on March 31, 1965 notwithstanding that his employment agreement (Joint Exhibit 2-B) specified a December 31, 1965 termination; that on or prior to March 31, 1965, Logan's auditors had certified that Logan's gross sales and net profit for the year ending December 31, 1964 had increased not by 5% as required by the Stock Option Agreement but by 500%. Under the facts of the hypothetical, could it seriously be contended that Guild had agreed that he, under such circumstances, should have no right to any of the Logan shares because he had failed to survive as a Logan employee for one more day.

It might be urged that, under the facts of the hypothetical, Guild would have an action for damages, but since the damages could not be measured[1] the case would be one

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(1) Damages would have to compensate the plaintiff for the loss of his opportunity to derive capital gain treatment of his profit on the sale of the shares. Such treatment is obtainable only if no sale of the stock received pursuant to the exercise of the option is made within two years of the grant of the option nor within six months of the transfer of the shares to the optionees. I.R.C. Section 424. In order to determine the plaintiff's damage the Court would therefore have to determine at what point in time and at what price the plaintiff would have sold the shares if he had received them and whether the requirements of Section 424 would then have been satisfied. Having determined what net profit the plaintiff would have made, then, assuming that the requirement of Section 424 would have been satisfied had the plaintiff received the shares in the first place, the Court would have to take account of the fact that a money judgment would be taxed

justifying a determination that the option was exercisable at the time of the discharge and that the stock ought to be awarded if an attempt to exercise the option had been seasonably made after the discharge.

The outcome in this case should be no different because Guild was discharged in November, 1964. The facts are, as the parties have stipulated, that the earning standards set forth in the Stock Option Agreement were met, not alone for 1964, but for all of the years covered by the Stock Option Agreement.

The question then remains whether Guild was wrongfully discharged. The Court below said that it had not been established that he was. In so holding, the Tax Court ignored the convincing evidence in the case to the contrary - the only evidence bearing on the issue. The proof that Guild was wrongfully discharged is to be found in the Settlement Agreement itself and in the substance of the settlement.

The text of the Settlement Agreement is short and it bears repetition at this point:

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(1) Footnote continued.

as ordinary income to the plaintiff (Rank v. United States, 345 F.2d 337 (1965); Donald H. Kunsman, 49 T.C. 62 (1967) and enter upon the never ending chain of calculations to determine the amount which, taxed to the plaintiff at ordinary income rates, would net him the after capital gains tax profit he would have enjoyed but for the discharge. And if, perchance, the action were concluded within two years of the grant of the option, how could damages be calculated?

"November 20, 1967

Mr. Irwin C. Guild
139 East 33 Street
New York, New York

Dear Mr. Guild:

You will recall that on or about September 24, 1963, we granted to you an option to purchase 25,000 shares of our common stock. You exercised the option with respect to 10,000 shares, for which you paid the option purchase price of $15.46 per share and received the stock. You attempted further to exercise the option with respect to the remaining 15,000 shares, but your right to do so was questioned by us.

We do hereby recognize your right to 6,500 shares of our stock upon the terms and conditions of the option. You are delivering to us simultaneously with the execution hereof, the sum of $100,490, in full payment of said shares.

We shall cause our transfer agent to issue to you, forthwith, stock certificates representing 6,500 shares of our common stock and shall deliver same to your attorneys, Epstein & Furman, Esqs., 261 Madison Avenue, New York, New York.

Very truly yours,

JONATHAN LOGAN, INC.

By: Richard J. Schwartz
President

The above is accepted
and agreed to:

Irwin C. Guild
Irwin C. Guild"

For all its brevity the Settlement Agreement is pregnant with meaning. It makes it clear that the parties are referring to the Stock Option Agreement, (Joint Exhibit

3-C), which underlies this case and that what was being settled were Guild's rights thereunder. It confirms Guild's testimony of his efforts to exercise his option and the rejection by Logan of such exercise. Lastly, and most significantly, the Settlement Agreement establishes that Guild was wrongfully discharged by Logan. The fact of such wrongful discharge is established by Logan's recognition* of Guild's entitlement to the 6500 shares of Logan's stock "upon the terms and conditions of the option". If Guild had been discharged for cause he could not have had any rights to Logan's stock "upon the terms and conditions of the option" for Section 5 of the Stock Option Agreement specified that if Guild's employment were terminated for cause, all of his rights were to expire immediately upon such termination. To put it otherwise, shares of Logan's stock were subject to Guild's option after termination of employment only if such termination were not for cause, and the concession by Logan that its shares were subject to Guild's option constitutes a conclusive admission by Logan that its discharge of Guild was without justification and that he retained his option rights.

The substance of the Settlement Agreement demonstrates that Guild's claim which Logan recognized was that he had been wrongfully discharged and thus deprived of his option rights. This Court has the right to determine which of Guild's claims were given effect by the settlement.

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* Footnote appears on Page 19(a).

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* The word "recognize" is defined in Webster's Third New International Dictionary as follows:

"4: to acknowledge in some definite way: take notice of: as . . . c: to admit the fact or existence of (recognized the obligation). . ."

"Recognize" imports cognition of an existing state of facts (in this case, Guild's rights under the Stock Option Agreement). The Commissioner of Internal Revenue and Logan are attempting to have the word import the creation of a new condition or state of facts to give the sentence in which it was used the meaning: "We hereby grant (or award) you a right, which you never had before, to 6500 shares of Logan stock".

The Tax Court was guilty of the same error, saying: "Although after long negotiations Logan allowed Guild to purchase 6500 shares of stock at the option price, we do not view this fact as an admission by Logan that Guild could have exercised his option in November, 1964."

Compare George Eisler, 59 T.C. 634 (1973). Thus, while Guild asserted several claims against Logan, the only claim recognized by the Settlement Agreement - substantially as well as by the language of the document - was Guild's claim of a right to receive Logan stock under the Stock Option Agreement.

It requires very little study to reach the conclusion that none of the money claims which Guild asserted in his complaint were given any value in the settlement of the litigation for either the claims had no legal foundation at the outset (as Logan recognized, see Joint Exhibits 8-H and 9-I) or evaporated in the course of the year 1965 as a consequence of the receipt by Guild of as much or more from his new employer as he would have been entitled to receive from Logan.

The money damages sought by Guild for breach of his Employment Contract were specified in his complaint as follows:

(a) Salary (1)	$62,639.00
(b) Cash Expense Allowance	3,410.00
(c) Automobile	4,100.00
(d) Credit card (personal use)	2,733.00
(e) Trips abroad	6,000.00

(1) Guild's complaint alleged that his salary was at the agreed rate of $55,000 per annum notwithstanding that the Employment Agreement, Joint Exhibit 2-B, specified salary of $30,000 per annum and a non-accountable expense allowance of $25,000 per annum.

(f) Health insurance	$ 251.84
	$79,133.84

After being discharged by Logan, Guild received in 1965 from L'Aiglon Apparel, Inc., his new employer, compensation in the amount of $46,209.37 and the use without charge of a 1965 Cadillac (2)

Of Guild's specified items of money damages, the cash expense allowance, the credit card, the trips abroad and the health insurance were not recoverable under the law of New York since Paragraph 9 of the Employment Agreement specified that the Agreement constituted the entire understanding of the parties and that it could not be amended orally and no provision therein required Logan to provide such fringe benefits to Guild. Bethlehem Steel Co. v. Turner Const. Co., 2 N.Y.2d 456, 141 N.E.2d 590 (1957); Englehorn v. Reitlinger, 122 N.Y. 76 (1890); Laskey v. Rubel Corp., 303 N.Y. 69, 100 N.E.2d 140 (1951), and the Statute of Frauds. (Section 5-701, McKinneys General Obligations Law).

So much of the salary claim of $62,639 as consisted of the expense allowance specified in the Employment Agreement

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(2) The use without charge of the 1965 Cadillac which was provided to Guild by L'Aiglon Apparel, Inc. is assumed to have had at least the $4,100 value to Guild which he assigned to the use without charge of the 1964 Cadillac provided to him by Logan.

(at least $25,000 for 1965) was also not recoverable under the applicable New York law. Crabtree v. Elizabeth Arden Sales Corp. (Supreme Court N.Y. Co., 1951) 105 N.Y.S.2d 40 (not officially reported), aff'd without opinion, (1st Dept., 1952) 279 App. Div. 992, 112 N.Y.S.2d 494 aff'd, (1953) 305 N.Y. 48, 110 N.E.2d 551.

There is no question but that Logan comprehended the law of the State of New York to be as above stated (Joint Exhibit 9-I, p. 24 et seq.). Thus, after the unallowable claims are pared, it is evident that Guild had sustained no damage as a consequence of Logan's breach of the Employment Agreement for by the date of the settlement it had been established that the compensation which Guild had received for the year 1965 from L'Aiglon Apparel, Inc. exceeded that which he would have earned had Logan permitted him to work until the specified termination of his term of employment on December 31, 1965. The foregoing conclusion follows from the settled law of the State of New York which is to the effect that an employee's damage for wrongful discharge is measured by the wages which would have been payable during the remainder of the term of his employment, reduced by the income which the discharged employee had earned during the unexpired term, Hollwedel v. Duffy-Mott Co. (1934) 263 N.Y. 95, 188 N.E. 266, 9 Encyclopedia, New York Law (Damages), Section 537, p. 571.

In any event, quite apart from the Settlement

Agreement which makes it clear that the parties were concerning themselves only with Guild's right under the Stock Option Agreement, it is obvious that Logan was not settling a claim which at best would have amounted to less than $30,000.[3] by the transfer to Guild of property which might yield him up to a quarter of a million dollars in excess of the amount which Guild was being called upon to pay for it.

Having, we believe, established that Guild's discharge in November 1964 did not deprive him of his option right, it remains to be determined whether or not he seasonably exercised such option.

Under regulations, Section 1.421-1(e) an option is excercised when the optionee accepts the offer to sell contained in the option. The time of the actual transfer to him of the stock to which he became entitled through such exercise has no significance in the application of Section 421(a) of the Code, Revenue Ruling 70-335, I.R.B. 1970-26 p. 15, 1970-1 C.B. 111. It is therefore of no moment that actual transfer of the Logan stock to Guild was delayed by Logan, if it is

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(3) Even if all of Guild's claims for damages for breach of the Employment Agreement were allowed, his maximum recovery would have been the difference between the $79,133.84 which he claimed and the $50,309.37 which he received from L'Aiglon Apparel, Inc. (i.e. $46,209.37 of compensation plus $4,100 as the value of the free use of the 1965 Cadillac).

found that the exercise of the option by Guild satisfied the requirements of Sections 421(a) and 424(a) of the Code. (4)

The uncontroverted evidence in the case is that after being discharged by Logan on or about November 10, 1964, Guild repeatedly demanded of Logan that the 15,000 share balance of Logan stock which remained subject to his option, and for which he was then ready, willing and able to pay, be transferred to him. Since Guild did as much as it was within his power to do to obtain the shares by demanding them of Logan's President and simultaneously offering and having the ability to pay the specified option price for them, he "exercised" his option within the meaning of Sections 421(a) and 424(a) of the Code.

In holding that the option had not been exercised the Tax Court relied upon the facts that Guild had not tendered certified funds and had given to Logan no written notice of exercise of his option. The Tax Court, however, completely ignored Logan's admission that Guild had attempted to exercise the option and that Logan had not contested the validity of Guild's attempted exercise but only his right to the stock. (5)

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(4) The time of transfer of the stock to the optionee is significant only in respect to the optionee's satisfaction of the holding period requirement expressed in Section 424(a)(1) of the Code.

(5) "You attempted further to exercise the option . . ., but your right to do so was questioned by us." (Joint Exhibit 13-M)

Moreover, the law does not impose upon one the duty to perform futile gestures as the basis for the assertion of a right (Hawes v. Oakland, 104 U.S. 450), and in view of the action of Richard Schwartz, Logan's President, in categorically refusing to recognize that Guild had any rights, it would have been an act of sheer futility on Guild's part to have tendered a written notice and certified funds.(6) In any event, as the evidence established, Logan, on Guild's prior exercise of his option as to 10,000 shares of Logan's common stock, had accepted Guild's uncertified check (Guild Ex. 16) and had not insisted upon the requirement that the exercise of option be evidenced by a formal written notice, (App. p. 135a).

B.

Appellant's contend that regardless of whether in the period November 10, 1964 through January 15, 1965 (when Guild's federal court action was commenced) Guild then had or did not have the right under the Stock Option Agreement to exercise an option in respect of some or all of the remaining 15,000 shares of Logan's stock, the fact of the matter is that Guild did attempt such an exercise which was in fact recognized and given effect by Logan on the subsequent settlement.

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(6) Guild's investment representation, if one was required, was subscribed at the foot of the Stock Option Agreement.

The language of the Settlement Agreement ("You attempted however to exercise the option with respect to the remain ng 15,000 shares but your right to do so was questioned by us. ¶We do hereby recognize your right to 6500 shares of our stock upon the terms and conditions of the option.") and the treatment accorded to the issuance of the 6500 shares in Logan's records (snowing such shares to have been issued "upon (the) exercise of stock options" (Ex. 16)) establish as a fact that Guild's attempts to exercise his option in the latter part of 1964 and in the first half of January, 1965 were recognized and given effect by Logan. It is immaterial that the exercise of option thus given effect and recognition may have occurred at a date earlier than that which the Stock Option Agreement specified, for under Section 425(h)(3)(C) of the Code the acceleration of the time at which an option may be exercised is not a modification which Section 425(h)(1) of the Code requires to be considered as the grant of a new option.

Revenue Ruling 70-94 (1970-1 C.B. 112) is precisely in point. The ruling postulates the following facts:

An option is exercisable in five equal annual installments beginning on the first anniversary of the date of the grant; to the extent an installment is not exercised by the optionee on the applicable date, the shares not purchased accumulate and may be purchased at any time prior to the

expiration of the option; if the optionee dies while in the corporation's employ or within three months after ret. rement, his estate may exercise the option within twelve months after his death, but only to the extent that the optionee was entitled to exercise it immediately prior to his death; the option is amended to provide that in the event of the optionee's death while in the employ of the Company or within three months after retirement, his estate may exercise the option in full, even though the optionee, immediately prior to his death, could exercise only a portion of it.

The holding of the ruling is that the amendment to the option was "an acceleration of the time at which a portion of the option may be exercised with respect to an existing number of shares already subject to option, and is not a 'modification' within the meaning of Section 425(h)(3) of the Code".

There can be no question but that Guild and Logan were adverse parties who dealt with one another at arms length in developing the terms of the Settlement Agreement. Neither the respondent nor Logan has introduced any evidence to the contrary,(7) and they are, therefore, concluded by

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(7) Logan would, in any event, have been precluded by the parol evidence rule from offering oral testimony to vary or contradict the plain and unambiguous meaning of the Settlement Agreement.

the facts as established by the Settlement Agreement and Logan's treatment in its accounts of the issuance of the 6500 shares to Guild, Dudley G. Seay, 58 T.C. 32 (1972). These facts establish the recognition by Logan of Guild's exercise of option, and since the recognition of such exercise and giving effect thereto constitutes no more than an acceleration of the time of exercise and not a modification, such exercise satisfied the requirements of Sections 421(a) and 424(a) of the Code, so that as to 6112 shares of the 6500 shares received by Guild in November, 1967, the provisions of Section 421(a) of the Code are applicable.

Two simple illustrations will point up the validity of the position for which Guild is contending.

1. Assume that Corporation C has granted Employee E a restricted stock option which satisfies the requirements of Section 424(b) of the Code, and that such option may not be exercised prior to April 1, 1965. Assume, further, that on March 15, 1965, E delivers to C written notice of exercise of his option and tenders his check in full payment for the number of shares which C's stock option plan would first make available to E on April 1, 1965. No issue as to the prematurity of E's exercise of the option is raised by C, and upon C's receipt of E's notice of exercise of option and check, it acknowledges receipt of the notice and check, consents in writing to the acceleration of exercise, and transfers the shares to E.

We believe there is no question but that under Section 425(h(3)(C) there has been no modification of E's option; C has merely permitted the exercise date to be accelerated wherefore Section 421(a) applies and no income is realized by E on the transfer of the stock to him by C.

2. The facts are the same as in illustration (1) except that C takes no action to transfer the shares to E until April 15, 1965.

We believe that there would be no difference in result; that there has been no modification of E's option and that all that has happened is that C has permitted the exercise date to be accelerated.

The legislative history of Section 425(h)(3)(C) supports the foregoing conclusions. Thus, the Senate Report (Senate Report No. 830, 88th Cong., Second Session (1964), 1 U.S. Code Congressional and Administrative News 1673 states (at p. 1766)):

> ". . .Second, your committee has provided that where an option under the terms under which it was granted is not immediately exercisable in full, the employer can permit the exercise date for any or all of the remaining installments of the options to be accelerated without this change being considered a 'modification' which would require a new option price for the option for it to continue to constitute a qualified (or restricted) option. . ." (Emphasis ours).

In short, it is Guild's position that acceleration may be accomplished retrospectively by the transferor corporation recognizing and giving effect to what would otherwise

be the premature exercise of an option as well as by an amendment of the option which has prospective operation.

Since, as we have previously observed, the tax aspects of the transaction in issue are determined by the time of Guild's exercise of option rather than by the time of Logan's transfer of stock, the fact that Logan delayed for a period before recognizing Guild's exercise of option is of no consequence.

II.

IF GUILD REALIZED INCOME UPON RECEIPT OF THE LOGAN STOCK SUCH INCOME WAS WHOLLY OR IN MAJOR PART CAPITAL GAIN

A.

Under settled principles, the tax consequences which attach to Guild's receipt of the Logan stock are to be determined by reference to the nature of the claim in respect of which the settlement was made. Anchor Coupling Company v. United States, 427 F.2d 429, 433 (C.A.7), certiorari denied 401 U.S. 908; Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (C.A.1), certiorari denied 323 U.S. 779; Estate of Mabel K. Carter, 35 T.C. 326 (1960), affirmed 298 F.2d 192 (C.A.8); Revenue Ruling 67-33, 1967-2 C.B. 62. While Guild

asserted several claims against Logan, the only claim which was recognized by the settlement was Guild's claim of a right to receive Logan stock under the Stock Option Agreement. Compare George Eisler, 59 T.C. 634, (1973); Dudley G. Seay, supra.

We have demonstrated that Guild's exercise of his option under the Stock Option Agreement could have been immediately recognized and given effect by Logan as a mere acceleration of Guild's option (Section 425(h)(3)(C) of the Code), so that under Section 421(a) of the Code no income would have been recognized on the transfer of the Logan stock to him. Uner the principle established by the Raytheon, Anchor Coupling and Carter cases, the result is the same notwithstanding that Logan's recognition of Guild's right was accomplished under the compulsion of his lawsuit.

B.

If it be determined that Guild did not receive the Logan stock through the exercise of a restricted stock option, such a determination does not compel the conclusion that the respondent's determination was correct. There remains for consideration the issue of whether, under the circumstances of this case, Guild is not entitled to receive capital gain treatment of the spread between the market value of the Logan stock when he received it and the option price which he paid. We believe that he is, as the analysis which follows will demonstrate.

Exclusive of the possibility that Guild received the Logan stock pursuant to the Stock Option Agreement (as we have heretofore contended), the remaining possibilities are that such stock was received in exchange for his option rights or as damages for Logan's interference with his rights to stock option property.

Under Section 1234(a) of the Code, gain realized by Guild attributable to his exchange of his option or contract rights would be capital in nature Turzillo v. C.I.R., 346 F.2d 884 (C.A.6), unless such result is precluded by Section 1234(d)(2) as cases such as Rank v. United States, 345 F.2d 337 (C.A.5) and Donald H. Kunsman, 49 T.C. 62, if not otherwise distinguishable, would appear, upon incomplete analysis, to indicate.

In Rank and Kunsman the facts were that the taxpayer, in each case, was the holder of an unexercised statutory (i.e. restricted) stock option who exchanged his unexercised rights for cash, in the one case to enable his employer corporation to accomplish a transaction which was inhibited by the fact that taxpayer's option was outstanding, and in the other case upon the termination of employment.

Crucial to the decisions against the taxpayer, in these cases was the fact, as recognized by the court in Rank, (Page 340) that the allowance of capital gain treatment would have enabled the taxpayer to accomplish indirectly what the statute explicited prohibited:

"At the outset, it bears emphasis that had the stock been issued at this time and then sold -- either to a third party or back to the corporation -- the very same gains would clearly have been ordinary income since the stock would not have been held the requisite six months to qualify as a statutory restricted stock option. In other words, extinguishing for a consideration the option with its carefully built-in statutory restriction would, in practical effect, enable the parties to obtain the immediate income tax benefit free of the very conditions prescribed by Congress in this area of high controversy."

And again at Page 345:

"But it would be making the silk purse out of the sow's ear, if not performing the alchemist's feat, Duncan v. United States, 5 Cir., 1957, 247 F.2d 845, 848, to attribute capital gain treatment to the proceeds received for the extinguishment of an option where the fruits of such option then legally obtainable, if received and translated into the same cash at that very moment, would have been treated as ordinary income. Whatever deficiencies there might be in the express terminology of the statutory mechanism for privileged stock options, we are satisfied that when these and the sections of the Code covering income and affording the preferred status of capital gain are matched together, no one could attribute to Congress any such incongruous result."

Rank and Kunsman are, therefore, distinguishable upon several grounds. Neither of the taxpayers exercised their options and paid for or received his employer's stock. Guild, on the contrary, paid for and received the Logan stock in the manner contemplated by Sections 421 and 424 of the Code and the Stock Option Agreement.

Not having acquired the stock of his employer, neither Rank nor Kunsman sustained the investment risk of the holding period which the Congress built into the statutory scheme to justify the characterization of the statutory

options as incentive devices. Senate Report No. 2375, 81st Congress, 2nd Session (1950), 2 U.S. Code Congressional Service, Page 3115; neither does it appear in either of the cases that the optionee could not have exercised his option had he been prepared to make the investment required to purchase the optionor's stock. Guild, to the contrary, resorted to the only means available to him -- legal action -- to enforce his rights to acquire the Logan stock.

The taxpayers in Rank and Kunsman asserted the argument that the cash which they received from their respective employers constituted capital gain under Section 1234(a) of the Code. The court (originally in Rank, followed by Kunsman) held that Section 1234(c)(2) (now Section 1234(d)(2)) made Section 1234 inapplicable "when gain is realized on the surrender of compensatory stock options". Kunsman, supra, page 71.

When the legislative history of the restricted stock option, the requirements of the Code applicable thereto and Section 1234(d)(2) of the Code are all carefully considered, we can unhesitatingly subscribe to the conclusion of Rank and Kunsman when it is understood to be limited to the facts of those cases -- the exchange of statutory option rights for cash. We can also subscribe to the view of the court in Rank that Section 1234(c)(2) [now Section 1234(d)(2)] expressed the purpose of the Senate Committee to exclude "employee compensatory

stock options" from the operation of Section 1234(a). However, the committee could not have had statutory options in contemplation when it amended Section 1234 by the Technical Amendments Act of 1958, P.L. 85-866, §53, 72 Stat. 1606 for the legislative history of the restricted stock option provisions establishes irrefutably that Congress did not consider the restricted stock option to be a compensatory device:

". . .The options which qualify for special treatment (i.e. restricted stock options, our note) are regarded as incentive devices rather than compensation. . ." (Senate Report 2375, supra, p. 3115).

This view derives support from the fact that the restricted stock option is also non-transferable otherwise than by will or the laws of descent and distribution (Section 424(b)(2)), and it is hardly to be supposed that Congress was taking the trouble to amend Section 1234 to reinforce the denial of capital gain treatment in the event of transfer when such denial was already explicit in the restricted stock option provisions. See, in that connection, Revenue Ruling 73-146, I.R.B. 1973-13,5, as follows:

> "Section 422(b)(6) of the Code provides that a qualified stock option by its terms must not be transferable by the optionee otherwise than by will or by the laws of descent and distribution. Since the options in this case were in effect transferred by the optionees prior to exercise, otherwise than by the laws of descent and distribution, the rules of Section 421 of the Code, which operate only under

> the exercise of a qualified stock option, were inapplicable to the transfer (cancellation) of the options back to M."

Undoubtedly, what the Congress had in mind was to prevent the conversion of ordinary income under Smith and Lo Bue options (Commissioner v. Smith, 1945, 324 U.S. 177; Commissioner v. Lo Bue, 1955, 351 U.S. 243) into capital gains through the medium of an assignment of the contract right. In this view of Section 1234(d)(2) the Court in Rank and Kunsman were correct in their decisions since the statutory options in those cases lost their character as such and became Smith-LoBue options upon their transfer or assignment for cash.

We do not contend that under all circumstances Section 1234(a) is applicable to an exchange of an optionee's rights under a statutory option contract for the optioner's stock and that such an exchange produces capital gain treatment. We do, however, contend that under the circumstances of this case in which the option right was exchanged for the stock which was subject to the option, the operation of Section 1234(a) is not precluded by Section 1234(d)(2).

III.

EVEN IF THE TRANSFER OF THE LOGAN STOCK TO GUILD WAS NOT IN PURSUANCE OF HIS EXERCISE OF A STATUTORY OPTION, SUCH TRANSFER WAS NOT A TAXABLE EVENT, AND NO INCOME WAS DERIVED BY GUILD AS A CONSEQUENCE OF SUCH TRANSFER.

In the Tax Court the Commissioner of Internal Revenue (and Logan) took the position in their post-trial briefs that the language of the Settlement Agreement ("We do hereby recognize your right to 6500 shares of our stock upon the terms and conditions of the option") merely indicated that the Logan stock which Guild was acquiring was subject to the investment restrictions imposed by the Stock Option Agreement. Inasmuch as the Tax Court gave no effect to Guild's contention that the Settlement Agreement constituted an admission by Logan of Guild's timely exercise of his statutory option, it necessarily concluded that the Settlement Agreement incorporated by reference the Federal securities law restrictions on transferability contained in the underlying Stock Option Agreement. If then the Logan stock which Guild received was subject to restrictions upon sale and such restrictions had a significant effect upon its value, no income was realized by Guild when the stock was transferred to him because of the application of Regulation 1.421-6.

We can not improve upon the Commissioner's statement of the position as set forth in the Internal Revenue Manual (and first published after the opinion in this case had been announced), Internal Revenue Manual, Prime Issue No. 0421.01-01; Commerce Clearing House Internal Revenue Manual, page 1473-6, and therefore set forth its relevant portions.

> "8 If the option does not have a "readily ascertainable market value" at grant, the appropriate time for realizing ordinary income and the amount thereof are detailed in Regs. 1.421-6(d). Under Regs. 1.421-6(d)(1) ordinary income will be realized after the option is exercised and when an "unconditional right" to receive the property subject to the option is acquired. And the amount realized is the excess of the fair market value of the property at such time over the amount payable for the property. If, however, at the time such "unconditional right" is acquired, the property is subject to a "restriction which has a significant effect on value" ordinary income will not be realized until the time such restriction lapses or the property is sold or exchanged, in an arm's length transaction, whichever event occurs earlier. And the amount of ordinary income realized will be the lesser of the difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition or the difference between the amount paid for the property and either the fair market value of the property at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable. (Where underscored, emphasis added.)
>
> 9. One of the principal issues arising under Regs. 1.421-6(d)(2) and also under Regs. 1.421-6(c)(3)(i)(c) is whether the option or property subject to "any restriction having a significant effect" upon the value of the options or the property. Included among such restrictions, and most common, are the following:

a. . .

b. . .

c Under the terms of the option, the option or the property subject to the option is subject to the restrictions imposed by Federal securities laws; Ira Hirsch, supra, [5 I.T.C. 121 (1968)] or state securities law; brief position in Estate of Ralph B. Campbell, 56 T.C. 1 (1971).

10 With respect to restrictions imposed by the Federal securities law, the Service agrees with Ira Hirsch that such restriction, if the particular and detailed facts so demonstrate, could constitute restrictions having a significant effect on value. Accordingly, the opinion of the Court of Appeals for the Seventh Circuit in Frank v. Commissioner, 447 F.2d 552, 27 AFTR 2d 71-1574 (75h Cir. 1971), is in error to the extent it holds that restrictions imposed by the Federal securities laws could never, as a matter of law, constitute restrictions having a significant effect on value. As to when such restrictions would lapse, see the Auction on Decision in Ira Hirsch, supra, dated July 1, 1970."

While Regulation 1.421-6 speaks of options, the Regulation is equally applicable to the transfer of the Logan stock to Guild since Regulation 1.61-2(d)(5) specifies that when property is transferred to an employee as compensation for services and the property so transferred is subject to a restriction which has a significant effect on its value, the rules of paragraph (d)(2) of Regulation 1.421-6 shall be applied in determining the time (and amount) of compensation to be included in the gross income of the employee. Regulation 1.421-6(d)(2) provides that in a case in which such property is received by a person, the employee realizes compensation when the restriction lapses.

Clearly, such is the rule which should apply in this case if it be determined that Guild did not exercise a statutory option, for it is clear as a matter of law that investment representations which impose restrictions on transferability which are designed to prevent violations of the federal securities laws have a significant effect on value. Jack I. LeVant, 45 T.C. 175; and see Amerada Hess Corporation v. Commissioner of Internal Revenue, 497 F.2d 862 (C.A.3), (1975).

Such being the case, the Tax Court erred as a matter of law in holding that income was realized by Guild on the transfer of the Logan stock to him.

As heretofore noted, the position of the Internal Revenue Service on this issue was first announced after the publication of the Tax Court's decision in this case. Also, the Commissioner and Logan first raised in their post-trial briefs the argument that the Settlement Agreement did no more than to impose the transfer restrictions on the Logan stock. Appellants thereupon sought to raise the issue before the Tax Court by their motion for reconsideration and on the Rule 155 computation of the deficiency. Their efforts in both instances were unavailing. Under the circumstances, if this Court finds that it cannot reverse the Tax Court and find for the appellants, the case should be remanded to the Tax Court for further proceedings on this issue.

Conclusion

This Court should hold that Guild exercised a statutory option and that no income was realized by him on such exercise; that if it be held that Guild exchanged his statutory option rights for Logan stock, such exchange was in the nature of a capital transaction rather than in a transaction giving use to ordinary income consequences; and, finally, that if the settlement between Guild and Logan was of a controversy related to his employment contract, the Logan stock was subject to restrictions having a significant effect on value which operated to preclude the event of transfer from being a taxable event.

RESPECTFULLY SUBMITTED,

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Appendix

Internal Revenue Code

Regulations

STOCK OPTIONS • RESTRICTED STOCK

[¶ 2676] GENERAL RULES

Sec. 421 [1954 Code]. (a) EFFECT OF QUALIFYING TRANSFER.—If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 423(a), or 424(a) are met—

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(b) EFFECT OF DISQUALIFYING DISPOSITION.—If the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a), 423(a), or 424(a) except that there is a failure to meet any of the holding period requirements of section 422(a)(1), 423(a)(1), or 424(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

(c) EXERCISE BY ESTATE.—

(1) IN GENERAL.—If an option to which this part applies is exercised after the death of the employee by the estate of the decedent or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of subsection (a) shall apply to the same extent as if the option had been exercised by the decedent, except that—

(A) the holding period and employment requirements of sections 422(a), 423(a), and 424(a) shall not apply, and

(B) any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of sections 423(c) and 424(c)(1).

(2) DEDUCTION FOR ESTATE TAX.—If an amount is required to be included under section 422(c)(1), 423(c), or 424(c)(1) in gross income of the estate of the deceased employee or of a person described in paragraph (1), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the option. For this purpose, the deduction shall be determined under section 691(c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) were an amount included in gross income under section 691 in respect of such item of gross income.

(3) BASIS OF SHARES ACQUIRED.—In the case of a share of stock acquired by the exercise of an option to which paragraph (1) applies—

(A) the basis of such share shall include so much of the basis of the option as is attributable to such share; except that the basis of such share shall be reduced by the excess (if any) of (i) the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) if the employee had exercised the option on the date of his death and had held the share acquired pursuant to such

'54 Code

[¶ 2676]—Continued

exercise at the time of his death, over (ii) the amount which is includible in gross income under such section; and

(B) the last sentence of sections 422(c)(1), 423(c), and 424(c)(1) shall apply only to the extent that the amount includible in gross income under such sections exceeds so much of the basis of the option as is attributable to such share.

Sec. 424 [1954 Code]. (a) IN GENERAL.—Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted stock option, if—

(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, and

(2) at the time he exercises such option—

(A) he is an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, or

(B) he ceased to be an employee of such corporations within the 3-month period preceding the time of exercise.

(b) RESTRICTED STOCK OPTION.—For purposes of this part, the term "restricted stock option" means an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of subsection (c)(3), an option granted after December 31, 1963), to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(1) at the time such option is granted—

(A) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(B) in the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted;

(2) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him;

(3) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This paragraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option, and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after August 16, 1954. For purposes of this paragraph, the provisions of section 425(d) shall apply in determining the stock ownership of an individual; and

(4) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(c) SPECIAL RULES.—

(1) OPTIONS UNDER WHICH OPTION PRICE IS BETWEEN 85 PERCENT AND 95 PERCENT OF VALUE OF STOCK.—If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subsection (b)(1)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

(A) in the case of a share of stock acquired under an option qualifying under subsection (b)(1)(A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(i) the fair market value of the share at the time of such disposition or death, or

(ii) the fair market value of the share at the time the option was granted; or

(B) in the case of stock acquired under an option qualifying under subsection (b)(1)(B), an amount equal to the lesser of—

(i) the excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(ii) the excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of a disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(2) VARIABLE PRICE OPTION.—For purposes of subsection (b)(1), the term "variable price option" means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; except that in the case of options granted after September 30, 1958, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised.

(3) CERTAIN OPTIONS GRANTED AFTER DECEMBER 31, 1963.—For purposes of subsection (b), an option granted after December 31, 1963, meets the requirements of this paragraph if granted pursuant to—

(A) a binding written contract entered into before January 1, 1964, or

(B) a written plan adopted and approved before January 1, 1964, which (as of January 1, 1964, and as of the date of the granting of the option)—

(i) met the requirements of paragraphs (4) and (5) of section 423(b), or

(ii) was being administered in a way which did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

'54 Code

Sec. 425 [1954 Code]. (a) CORPORATE REORGANIZATIONS, LIQUIDATIONS, ETC.—For purposes of this part, the term "issuing or assuming a stock option in a transaction to which section 425(a) applies" means a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if—

(1) the excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(2) the new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

For purposes of this subsection, the parent-subsidiary relationship shall be determined at the time of any such transaction under this subsection.

(b) ACQUISITION OF NEW STOCK.—For purposes of this part, if stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies, and such distribution was made with respect to stock transferred to him upon his exercise of the option, such stock shall be considered as having been transferred to him on his exercise of such option. A similar rule shall be applied in the case of a series of such distributions.

(c) DISPOSITION.—

(1) IN GENERAL.—Except as provided in paragraph (2), for purposes of this part, the term "disposition" includes a sale, exchange, gift, or a transfer of legal title, but does not include—

(A) a transfer from a decedent to an estate or a transfer by bequest or inheritance;

(B) an exchange to which section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies; or

(C) a mere pledge or hypothecation.

(2) JOINT TENANCY.—The acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship or a subsequent transfer of a share of stock into such joint ownership shall not be deemed a disposition, but a termination of such joint tenancy (except to the extent such employee acquires ownership of such stock) shall be treated as a disposition by him occurring at the time such joint tenancy is terminated.

(d) ATTRIBUTION OF STOCK OWNERSHIP.—For purposes of this part, in applying the percentage limitations of sections 422(b)(7), 423(b)(3), and 424(b)(3)—

(1) the individual with respect to whom such limitation is being determined shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(2) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

'54 Code

[¶ 2696]—Continued

(e) PARENT CORPORATION.—For purposes of this part, the term "parent corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(f) SUBSIDIARY CORPORATION.—For purposes of this part, the term "subsidiary corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(g) SPECIAL RULE FOR APPLYING SUBSECTIONS (e) AND (f).—In applying subsections (e) and (f) for purposes of section 422(a)(2), 423(a)(2), and 424(a)(2), there shall be substituted for the term "employer corporation" wherever it appears in subsections (e) and (f) the term "grantor corporation", or the term "corporation issuing or assuming a stock option in a transaction to which section 425(a) applies", as the case may be.

(h) MODIFICATION, EXTENSION, OR RENEWAL OF OPTION.—

(1) IN GENERAL.—For purposes of this part, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal shall be considered as the granting of a new option.

(2) SPECIAL RULES FOR SECTIONS 423 AND 424 OPTIONS.—

(A) In the case of the transfer of stock pursuant to the exercise of an option to which section 423 or 424 applies and which has been so modified, extended, or renewed, then, except as provided in subparagraph (B), the fair market value of such stock at the time of the granting of such option shall be considered as whichever of the following is the highest:

(i) the fair market value of such stock on the date of the original granting of the option,

(ii) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal.

(B) Subparagraph (A) shall not apply with respect to a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(3) DEFINITION OF MODIFICATION.—The term "modification" means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option—

(A) attributable to the issuance or assumption of an option under subsection (a);

(B) to permit the option to qualify under sections 422(b)(6), 423(b)(9), and 424(b)(2); or

(C) in the case of an option not immediately exercisable in full, to accelerate the time at which the option may be exercised.

If a restricted stock option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

(i) STOCKHOLDER APPROVAL.—For purposes of this part, if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

(j) CROSS REFERENCES.—For provisions requiring the reporting of certain acts with respect to a qualified stock option, options granted under employer stock purchase plans, or a restricted stock option, see section 6039.

(d) *Compensation paid other than in cash*—(1) *In general.* If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. However, for special rules relating to certain options received as compensation, see § 1.61-15 and section 421 and the regulations thereunder.

(2)(i) *Property transferred to employee or independent contractor.* Except as otherwise provided in section 421 and the regulations thereunder (relating to employee stock options) and § 1.61-15, if property is transferred by an employer to an employee, or if property is transferred to an independent contractor, as compensation for services for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

REG. SEC.
1.61-2(d)

(ii) (a) *Cost of life insurance on the life of the employee.* Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee. However, the amount includible in the employee's gross income is determined with regard to the provisions of section 403 and the regulations thereunder in the case of an individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection and which satisfies the requirements of section 401(g) and § 1.401-9, relating to the nontransferability of annuity contracts. For the special rules relating to the includibility in an employee's gross income of an amount equal to the cost of group-term life insurance on the employee's life as defined in paragraph (b)(1) of § 1.79-1 which is carried directly or indirectly by his employer, see section 79 and the regulations thereunder. For special rules relating to the exclusion of contributions by an employer to accident and health plans for the employees, see section 106 and the regulations thereunder.

(b) *Cost of group-term life insurance on life of spouse or children of an employee.* Generally, the cost (determined under paragraph (d)(2) of § 1.79-3) of group-term life insurance on the life of the spouse or children of an employee paid by the employee's employer is part of the gross income of the employee. However, such cost is not required to be included in the employee's gross income if it is merely incidental. Such cost shall be considered incidental if the amount of such insurance payable upon the death of a spouse or of a child does not exceed $2,000.

(3) *Meals and living quarters.* The value of living quarters or meals which an employee receives in addition to his salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

(4) *Stock and notes transferred to employee or independent contractor.* Except as otherwise provided by section 421 and the regulations thereunder (relating to employee stock options) and § 1.61-15, if a corporation transfers its own stock to an employee or independent contractor as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee or independent contractor. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

Caution: Reg. § 1.61-2(d)(5) does not consider new Code Sec. 83 added by the Tax Reform Act of 1969, P. L. 91-172. See ¶ 899X.01.

(5) *Property transferred subject to restrictions.* Notwithstanding any other provision of this paragraph, with respect to any property, other than an option to purchase stock or property, which is transferred by an employer to an employee or independent contractor as compensation for services, and which is subject to a restriction which has a significant effect on its value, the

Caution: Reg. § 1.61-2(d)(5) does not consider new Code Sec. 83 added by the Tax Reform Act of 1969, P. L. 91-172. See ¶ 899X.01.

[¶ 643]—Continued

rules of paragraph (d)(2) of § 1.421-6 shall be applied in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. For special rules relating to options to purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder. This subparagraph is applicable only to transfers after September 24, 1959. [Reg. § 1.61-2.]

.001 Historical Comment: Proposed 11/2/56. Adopted 11/25/57 by T. D. 6272. Amended 9/24/59 by T. D. 6416. Amended 12/11/63 by T. D. 6696 to provide rules for the tax treatment of certain options. Amended 10/19/65 by T. D. 6856 to correct cross references. Amended 7/5/66 by T. D. 6888 to reflect Sec. 204 of P. L. 88-272.

[¶ 2676A] § 1.421-1. Effective dates and meaning and use of certain terms—(a) *Option.* (1) For the purpose of section 421, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at $85 per share during 1955, or at $75 per share during 1956, or at $65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at $85 per share during 1955, an alternative option for the purchase of 1,000 shares at $75 per share during 1956, and a third alternative option for the purchase of 1,000 shares at $65 per share during 1957.

(b) *Time and date of granting of option.* (1) For the purpose of section 421, the words "the date of the granting of the option" and "the time such option is granted", and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer

of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 421(d)(5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporation action, such as the approval of some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its parent or subsidiary corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) *Stock.* For the purpose of section 421, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price.* (1) For the purpose of section 421, the term "option price" or "price paid under the option" means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2)(i) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(*a*) The option price must be fixed or determinable at the time the option is granted; or

(*b*) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option price must be determinable under a variable price option as defined in subdivision (ii) of this subparagraph.

An option which does not meet the requirements of either (*a*) or (*b*) of this subdivision when granted will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see paragraph (c)(2) of § 1.421-4.

[¶ 2676A]—Continued

(ii) (*a*) The term "variable price option" means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Except as provided in (*b*) of this subdivision, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than $85, nor more than $110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than $95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed $100,000, the option price shall be $15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed $100,000, the option price shall be $20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a) (1) of § 1.421-2.

(*b*) In the case of an option granted after September 30, 1958, the term "variable price option" does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised. Whether an option meets the requirement of this subdivision shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial. Thus, an option, granted after December 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this subdivision, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 421(d)(1)(A). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than $85, will not qualify under this subdivision since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement

of this subdivision is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(e) *Exercise.* For the purpose of section 421, the term "exercise," when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exericse of an option so long as the payments made remain subject to withdrawal by the employee.

(f) *Transfer.* For the purpose of section 421, the term "transfer," when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(g) *Effective dates.* Sections 1.421-1 through 1.421-5 are applicable only to options granted after February 26, 1945, and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, before the amendments made by section 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421-6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421-7 and 1.421-8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended. [Reg. § 1.421-1.]

[¶ 2680] § 1.421-6. Options to which section 421 does not apply.—(a) *Scope of section.* (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a qualified or restricted stock option at the time it is granted or an option granted under an employee stock purchase plan, or when an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of the parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property. In addition, § 1.61-15 makes the rules of this section applicable in determining the time when certain other options result in the realization of income and the amount of such income.

(2) This section is applicable only to options granted on or after February 26, 1945, except that this section is not applicable to—

(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred subject to a restriction which has a significant effect on its value, or

(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if, under the terms of the contract granting such option, the property to be transferred upon exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction.

However, if an option granted before September 25, 1959, and on or after February 26, 1945, is sold or otherwise disposed of before exercise, the provisions of this section shall be fully applicable to such disposition.

(3) If an option to which this section applies has a readily ascertainable fair market value when granted, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option, irrespective of whether such value was included in income for the taxable year in which the option was granted, and any deduction which is allowable as a result of the granting of such option is allowable only for the taxable year in which the option is granted. Thus, if an option having a readily ascertainable fair market value to which this section applies was granted in a taxable year for which an assessment of deficiency was barred at the time of the adoption of paragraph (c) of this section as a Treasury decision, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option. However, if there is a determination to which the rules of sections 1311-1314 apply, there may be an adjustment for the taxable year in which the option was granted.

(b) *Meaning and use of certain terms.* (1) For the purpose of this section, the term "option" includes the right or privilege of a person to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such person being under no obligation to purchase.

(2) As used in this section, the terms "employee", "employment", and "employer" have reference to the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401(c) and the regulations thereunder.

(3) For purposes of applying the rules of this section to the options which are made subject to such rules by § 1.61-15—

(i) The term "employee" includes the person who provided the consideration resulting in the grant of the option, the term "employer" includes the person to whom, or for whom, such consideration was provided, and the term "employment" includes the providing of such consideration;

(ii) Where a stock option is granted to an underwriter prior to a public offering and such grant is expressly or impliedly conditional upon the successful completion of the underwriting, the date on which the option shall be considered "granted" shall be the date of the successful completion of the underwriting.

(c) *Options with a readily ascertainable fair market value.* (1) If there is granted an option to which this section applies and which has a readily ascertainable fair market value (determined in accordance with subparagraphs (2) and (3) of this paragraph) at the time the option is granted, the employee in connection with whose employment such option is granted realizes

[¶ 2680]—Continued

compensation at such time in an amount equal to the excess, if any, of such fair market value over any amount paid for the option. If an option to which this section applies does not have a readily ascertainable fair market value at the time the option is granted, the time when the compensation is realized and the amount of such compensation shall be determined under paragraph (d) of this section.

(2) Although options may have a value at the time they are granted, that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031-2 of this chapter (the Estate Tax Regulations).

(3) (i) When an option is not actively traded on an established market, the fair market value of the option is not readily ascertainable unless the fair market value of the option can be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(*a*) The option is freely transferable by the optionee;

(*b*) The option is exercisable immediately in full by the optionee;

(*c*) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option or such property; and

(*d*) The fair market value of the option privilege is readily ascertainable in accordance with subdivision (ii) of this subparagraph.

(ii) The fair market value of an option includes the value attributable to the option privilege and may include the value attributable to the right to make an immediate bargain purchase of the property subject to the option. If the option provides an option price which is less than the fair market value of the property subject to the option at the time it is granted, an immediate gain may be realized by exercising the option at the bargain price and selling the property so acquired. However, irrespective of whether there is a right to make an immediate bargain purchase of the property subject to the option, the fair market value of the option includes the value of the option privilege. The option privilege is the opportunity to benefit at any time during the period the option may be exercised from any appreciation during such period in the value of the property subject to the option without risking any capital. Therefore, the fair market value of an option is not merely the difference which may exist at a particular time between the option price and the value of the property subject to the option but also includes the value of the option privilege. Accordingly, for purposes of this section, the fair market value of the option is not readily ascertainable unless the value of the option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(*a*) Whether the value of the property subject to the option can be ascertained;

(*b*) The probability of any ascertainable value of such property increasing or decreasing; and

(*c*) The length of the period during which the option can be exercised.

(d) *Options without a readily ascertainable fair market value.* If there is granted an option to which this section applies, and if the option does not have a readily ascertainable fair market value at the time it is granted, the employee in connection with whose employment the option is granted is considered to realize compensation includible in gross income under section 61 at the time and in the amount determined in accordance with the following rules of this paragraph:

(1) Except as provided in subparagraph (2) of this paragraph, if the option is exercised by the person to whom it was granted, the employee realizes compensation at the time an unconditional right to receive the property subject to the option is acquired by such person, and the amount of such compensation is the difference between the amount payable for the property and the fair market value of the property at the time an unconditional right to receive the property is acquired. An individual has an unconditional right to receive the property subject to the option when his right to receive such property is not subject to any conditions, other than conditions that may be performed by him at any time. Thus, if an individual who has exercised an option has a right to make payment for the property at any time and to receive the property immediately after making such payment, such individual realizes compensation at the time he exercises the option. However, if an individual who has exercised an option is prevented by the terms of the option contract from making payment immediately or from receiving an immediate transfer of the property after making payment, such individual does not realize compensation at the time he exercises the option. Such individual will not realize compensation until he does acquire the right to make payment immediately and to receive an immediate transfer of the property. For purposes of this paragraph, an unconditional right to receive the property subject to the option shall not be considered to have been acquired before the date on which the option is exercised.

(2) (i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—

(*a*) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(*b*) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includible in gross income at the time of such sale or exchange, but the amount includible in gross income under this subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includible in gross income as a result of the sale or exchange not at arm's length.

[¶ 2680]—Continued

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). On November 1, 1959, X Corporation grants to E, an employee, an option to purchase 100 shares of X Corporation stock at $10 per share. Under the terms of the option, E will be subject to a binding commitment to resell the stock to X Corporation at the price he paid for it in the event that his employment terminates within 2 years after he acquires the stock, for any reason except his death. Evidence of this commitment will be stamped on the face of E's stock certificate. E exercises the option and acquires the stock at a time when the stock, determined without regard to the restriction, has a fair market value of $18 per share. Two years after he acquires the stock, at which time the stock has a fair market value of $30 per share, E is still employed by X Corporation. E realizes compensation upon the expiration of the 2-year restriction and the amount of the compensation is $800. The $800 represents the difference between the amount paid for the stock ($1,000) and the fair market value of the stock (determined without regard to the restriction) at the time of its acquisition ($1,800), since such value is less than the fair market value of the stock at the time the restriction lapsed ($3,000).

Example (2). Assume, in example (1), that E dies one year after he acquires the stock, at which time the stock has a fair market value of $25 per share. Since the restriction lapses upon E's death, he realizes compensation of $800 ($1,800 less $1,000) and this amount is includible in E's gross income for the taxable year closing with his death.

Example (3). Assume that, pursuant to the exercise of an option not having a readily ascertainable fair market value to which this section applies, an employee acquires stock subject to the sole condition that, if he desires to dispose of such stock during the period of his employment, he is obligated to offer to sell the stock to his employer at its fair market value at the time of such sale. Since this condition is not a restriction which has a significant effect on value, the employee realizes compensation upon acquisition of the stock.

Example (4). Assume, in example (3), that the employee is obligated to offer to sell the stock to his employer at its book value rather than at its fair market value. Since this condition amounts to a restriction which has a significant effect on value, the employee does not realize compensation upon acquisition of the stock, but he does realize such compensation upon the lapse of the restriction, such as, for example, his death or the termination of his employment.

(3) If the option is not exercised by the person to whom it was granted, but is transferred in an arm's length transaction, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting.

(4) If the option is not exercised by the person to whom it was granted, but is transferred in a transaction which is not at arm's length, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting. Moreover, the employee realizes additional compensation at the time and in the amount determined under subparagraph (1), (2), or (3) of this paragraph, except that the amount of compensation determined under subparagraph (1), (2), or (3) of this para-

graph shall be reduced by any amount previously includible in gross income as a result of such transfer of the option. For example, if in 1960 an employee is granted an option not having a readily ascertainable fair market value to buy a share of stock for $50 at a time when the stock has a fair market of $100, and later in 1960 the employee transfers, in a transaction not at arm's length, the option to his wife for $10, the employee realizes compensation of $10 in 1960. If in 1961 the wife exercises the option at a time when the stock has a fair market value of $120, the employee realizes additional compensation in 1961 in the amount of $60 (the $70 bargain spread less the $10 taxed as compensation in 1960). For the purpose of this subparagraph, if a person other than the employee dies holding an unexercised option at a time when the employee is still living, the transfer which results by reason of the death of such person is a transfer in a transaction which is not at arm's length.

(5) If there is granted an option to which this section applies, and the employee dies before realizing the compensation in accordance with the rules of this paragraph, income having the character of compensation is realized at the time and in the amount determined under this paragraph by the person who transfers or exercises the option, or the person who receives the property subject to a restriction which has a significant effect on its value. For example, this subparagraph is applicable:

(i) When an option not having a readily ascertainable fair market value is granted to an employee, and he dies before transferring or exercising the option,

(ii) When an option not having a readily ascertainable fair market value is granted to the employee, and he dies after the transfer of the option in a transaction which is not at arm's length, but before the option is exercised, or

(iii) When an option not having a readily ascertainable fair market value is granted to another person, and the employee dies before realizing all of the compensation which would result from any transfer or exercise of the option. If the option is one which was granted to the employee and he dies before transferring or exercising the option, the option shall be considered a right to receive income in respect of a decedent to which the rules of section 691 apply. In any such case, if the option is transferred, section 691 provides that the amount received for such transfer or the fair market value of the property transferred at the time of transfer, whichever is greater, is income realized at the time of such transfer. Moreover, if a transfer is subject to this rule, it will be treated as a transfer in an arm's length transaction for the purpose of this paragraph.

(6) If an option to which this section applies is exercised in part and transferred in part, the rules of this paragraph shall be applied as if there were two options—one exercised and one transferred.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section 421(b) and paragraph (b) of § 1.421-8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421-5) and, in the case of a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, the amount of such

[¶ 2680]—Continued

compensation shall be subject to the limitation provided by section 422(c)(4) and paragraph (b) of § 1.422-1.

(e) *Basis.* (1) If an option to which this section applies is exercised by the person to whom it was granted, such person's basis for the property so acquired shall be increased by any amount that is includible in the gross income of the employee under paragraph (d) of this section. If such person transfers such property to a person whose basis is the same as the transferor's basis, such transferee's basis shall also reflect the adjustment made by this paragraph. However, if such property is transferred by either of such persons at death so that its basis is determined under section 1014, the basis so determined shall not be increased by reason of this paragraph.

(2) If an option to which this section applies is transferred in a transaction which is not at arm's length, the transferee who exercises the option shall increase his basis for the property so acquired by any amount that is includible in the gross income of the employee at the time such transferee acquires the property.

(3) If an option to which this section applies is transferred in a transaction which is at arm's length, the basis of the property acquired by an exercise of the option shall not be increased by reason of any amount that is includible in the gross income of the employee under this section.

(4) If an option to which this section applies has a readily ascertainable fair market value at the time it is granted, the basis of such option includes any amount includible in gross income of the employee under paragraph (c) of this section.

(f) *Deductions.* If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) or (d) of this section to have realized compensation. The deductibility of the amount considered so paid is determined under section 162 or other provision of the Code which is applicable to such a payment. Whether such amount may be deducted in the taxable year considered so paid, or whether such amount is a capital expenditure which is not deductible or which may be amortized, depends upon the nature of the transaction involved and the facts and circumstances of each case. If this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the employer's taxable year for which such compensation is deductible is determined under section 421(b) and paragraph (b) of § 1.421-8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421-5). [Reg. § 1.421-6.]

.01 **Historical Comment:** Proposed 11/10/56. Adopted 9/24/59 by T. D. 6416. Amended 7/13/60 by T. D. 6481 to redefine "employee," "employment," and "employer." Amended and reissued 1/19/61 by T. D. 6540, relating to fair market value of options. Amended 12/11/63 by T. D. 6696 to cover stock options granted to underwriters. Amended 6/23/66 by T. D. 6887 to reflect P. L. 88-272.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

IRWIN C. GUILD AND BERNICE GUILD
APPELLANTS-CROSS-APPELLEES

V.

COMMISSIONER OF INTERNAL REVENUE
APPELLEE-CROSS-APPELLANT

JONATHAN LOGAN, INC.

V.

COMMISSIONER OF INTERNAL REVENUE
APPELLEE
APPELLANT

STATE OF NEW YORK
CITY OF NEW YORK
COUNTY OF NEW YORK } ss.:

KENNETH A. POGANIK, being duly sworn, deposes and says, that he is over 18 years of age. That on the 3RD day of NOVEMBER, 1975, he served THREE COPIES of the attached BRIEF FOR APPELLANTS GUILD on the attorney for the APPELLEE-CROSS-APPELLANT (NO. 75-4123); APPELLANT (NO. 75-4201) herein by depositing the same, properly enclosed in a securely sealed

post-paid wrapper , in a U. S. Post Office at 90 Church Street, New

York City, directed to said attorney at ASSISTANT ATTY GEN. TAX DIVISION, DEPT. OF JUSTICE, WASH D.C. 20530 - ATT: GEORGE HULL, ESQ.

this being the place where he maintains an offices for the

regular transaction of business, and the last address mentioned in

the papers last served by CRAVEN GREEN RUDNICK & ZEIGLER

.....

Sworn to before me this

3 day of NOV. , 1975.

EUGENE KANE
Notary Public State of New York
No. 24-2026075
Qualified in Kings County
Commission Expires March 30, 1977

Service of ~~three~~ one ✓ copies of the within
is admitted this 3rd day of November 1975

Donna Vandermark,
Secretary to
Stephen L. Gardner